In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 280

UNITED STATES OF AMERICA, PETITIONER

v.

SKELLY OIL COMPANY

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

1. The respondent's brief diverts attention from the basic question here. The issue is not whether the Court should resurrect the "transactional" approach to revenue accounting, an approach that has been repeatedly rejected. On the contrary, this case arises solely because it is clear that the "transactional" approach is not accepted in federal tax law, and that annualized concepts of income tax accounting have been required. In annual accounting, however, the events of an earlier year must often be considered in order to determine the proper treatment of what occurs afterwards. That is the essence of the issue raised here.

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Respondent's basic contention in defense of the decision below is an argument that the court of appeals majority did not accept: that the amounts refunded in 1958 are deductible as ordinary business expenses rather than as a loss. Of course, cases such as *Healy* v. *Commissioner,* 345 U.S. 278, 284, indicate that what happened was a loss, and is deductible only as a loss.

The cases respondent relies on, *Kornhauser* v. *United States,* 276 U.S. 145; *Welch* v. *Helvering,* 290 U.S. 111; and *Commissioner* v. *Tellier,* 383 U.S. 687, are not inconsistent with this conclusion. *Kornhauser* and *Tellier,* as well as the pertinent dictum in *Welch* (290 U.S. at 114), are addressed to the question whether the expenses of defending certain lawsuits are deductible business expenses; the fact that they are has no bearing on the tax consequences of the refund of part of the purchase price paid by respondent's customers. The latter amounts, when paid to respondent, represented part of its "gross income from the property", which formed the basis for the percentage depletion that respondent claimed. The refund of those amounts necessarily means that respondent's gross income from mining has been adjusted downwards. Thus these payments are not analogous to such items as salaries—or the attorneys' fees ~~petitioner~~ respondent paid in defending against its customers' suits—that are deducted in the computation of net income, and would not be appropriately considered in determining what is gross income from the property for purposes of computing the depletion deduction.

2. Contrary to ~~petitioner~~ respondent's repeated suggestions (Br. 13, 15–16, 22), *Alice Phelan Sullivan Corp.* v. *United States*, 381 F. 2d 399 (Ct. Cl.), supports rather than refutes the government's position here. The problem in *Sullivan* involved the return to a taxpayer of property that had previously been given, in two parts, to a religious organization and had been the subject of two charitable deductions. Although the parties agreed that the return of the property should result in an addition to income for the later year, in the amount of the deductions earlier claimed and allowed, the taxpayer contended that its tax could be increased by no more than the amount by which its tax was reduced by reason of the earlier charitable deductions. The Court of Claims disagreed, and sustained the government's contention that the current year's tax rate was applicable to the full amount previously deducted.

In *Sullivan*, there was no question of depletion, and it could not be said there that the taxpayer was claiming a double deduction. However, the underlying rationale in *Sullivan* bears importantly on this case. The Court of Claims rested (381 F. 2d at 401) on a "principle * * * well engrained in our tax law that the return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery". Here the general problem is much the same, except that the receipt of money rather than its disposition was the subject of a percentage deduction in an earlier year. Because that receipt represented part of respondent's gross income

from the property, which gave rise to the depletion deduction, the repayments should result in the restoration of 27½% of that gross income allowed when received.

3. There is no foundation for respondent's assertions (Br. 11–12, 16–17, 20–22) that the issue here is *sui generis* and the decision below is not applicable to any other taxpayer. This case is by no means the last that will be heard of the problem. For example, petitioner errs in its assertion (Br. 20–21) that the question will not arise with respect to the natural gas producers involved in the *Permian Basin Area Rate Cases*, 390 U.S. 747. Even assuming *arguendo* that the rates set there will result in no federal income tax liability[1] on the natural gas production operations of a given taxpayer, it does not follow that the producer could not make use of a double deduction such as the court below has allowed respondent. When the natural gas there being regulated was produced and sold, depletion would surely have been claimed, either because taxable income was realized on the gas sold in those years, or because the gas revenues would be combined with oil revenues from the

[1] It is not clear that those producers would have no tax liabilities. The essential point of this Court's opinion is that the producers had failed to provide the necessary evidentiary support for a tax allowance; one possible inference of the contentions made in this Court is that some taxes were being paid. See 390 U.S. at 824 & n. 115. Cf. *Cities Service Gas Co.*, 30 F.P.C. 158, 163. Statistics available to the Internal Revenue Service indicate that oil and gas producers have an effective tax rate of about 7 to 9% of gross receipts, after depletion, but before any foreign tax credits that may be available. These data were part of the record before the FPC. See 3 Joint Appendix, cited in the *Permian* case, n. 115, *supra*, at p. 992.

property for purposes of computing depletion. Even if there is no taxable income from gas production as such in the later years when the refunds are made, the deduction allowed here, which is a loss deduction and not a depletion deduction, could be taken against income from other sources, or carried back against earnings of earlier years, or forward to later years.[2]

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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[2] Private tax rulings such as the one appended to respondent's brief cannot be relied upon by any party except the taxpayer to whom they are issued. *E.g.*, *Weller* v. *Commissioner*, 270 F. 2d 294 (C.A. 3); see, also, *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 468. We point out, however, that the ruling deals with the problem of apportioning certain expenses between mining and nonmining activities for purposes of computing gross income from mining. Cf. *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76. The only part that relates to the issue in this case is the last sentence, which takes the same position as we do here: "in those instances wherein refunds are allocated to gas sales at the wellhead, then the amount of refund [deducted] must be reduced by the depletion previously taken."

U.S. GOVERNMENT PRINTING OFFICE: 1968